KPMG

# Financial Reporting Matters

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AUDIT

This issue of *Financial Reporting Matters* highlights the recent amendments to the SGX Listing Rules. It also discusses how amendments to FRS 39 and FRS 104 affect accounting for financial guarantee contracts.

**The SGX listing rules were recently amended** to incorporate measures intended to raise corporate governance standards and promote good regulatory practices. These amendments are effective from 1 September 2006.

A key amendment is that directors of listed entities will be required to issue a "negative assurance" confirmation of their interim results. This amendment is to enhance the accountability of interim financial results.

**The amendments to FRS 39 *Financial Instruments: Recognition and Measurement* and FRS 104 *Insurance Contracts*** has changed the accounting treatment for financial guarantee contracts by the issuer (otherwise known as guarantor). The amendments are effective for annual financial periods beginning on, or after 1 January 2006.

The amendments require an issuer to account for a financial guarantee contract as a financial instrument within the scope of FRS 39.

However, if the issuer has previously asserted explicitly that it regards such a contract as an insurance contract, and has used accounting applicable to insurance contracts, the issuer may elect to account for the financial guarantee contract under FRS 104.

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## Latest Development

The International Financial Reporting Interpretation Committee (IFRIC) recently issued a new interpretation, IFRIC 10 Interim Financial Reporting and Impairment.

This interpretation states that an entity should not reverse an impairment loss recognised in a previous interim period, when these losses are pertaining to goodwill, investment in an equity instrument or financial assets carried at cost.

An entity should apply IFRIC 10 prospectively from the date it first applied IAS 36 or IAS 39. IFRIC 10 is effective for annual periods beginning on or after 1 November 2006. We expect the Council on Corporate Disclosure and Governance (CCDG) to issue a similar interpretation in Singapore soon. For more details, refer to IFRS Briefing Sheet 53.

# A. Amendments to the SGX Listing Rules – Main highlights

### Negative assurance confirmation on interim financial results

Directors of a listed entity are now required to provide a "negative assurance" confirmation of the accuracy of its interim financial results (quarterly or half-yearly, as applicable).

In announcing interim financial statements, these directors must provide a confirmation that to the best of their knowledge, nothing has come to the attention of the board of directors which may render the interim financial results false or misleading. There was previously no such requirement.

### Dilution of interest in a principal subsidiary

When determining if the disposal of shares in a principal subsidiary is material and requires shareholders' approval, the current rule does not take into consideration the effect of a concurrent issue of new shares by the subsidiary.

The effect of these two separate transactions taken together could result in a dilution of interest in the principal subsidiary by more than 20%. This is illustrated in the following example:

Subsidiary A issues new shares in an IPO which results in an increase of its shares by 15%. At the same time, the listed entity (parent) disposes 15% of its existing interest in Subsidiary A as vendor shares. The effect of the two transactions is as follows:

| | | |
|---|---|---|
| • Increase in new shares of Subsidiary A | 115% | (100% + 15%) |
| • Decrease in issuer's interest on disposal of vendor shares | 85% | (100% - 15%) |
| • Total decrease in issuer's interest in Subsidiary A | 74% | (85%/115%) |

In the above example, the disposal of 15% of the shares in Subsidiary A, on an individual basis, would not be considered a major transaction requiring shareholders' approval.

If the effect of disposing the subsidiary's shares and the issuance of new shares are considered together, the materiality threshold of 20% for shareholders' approval would be triggered.

The rule was amended to require a listed entity to consider concurrently the effects of disposing shares in a subsidiary and the issuance of new shares by the subsidiary.

### Composition of the board of directors

Under the revised rules, all listed entities should have at least two independent non-executive directors at the initial listing and on a continuing basis.

In addition, if the listed entity is foreign, there is a requirement for at least two independent directors to be resident in Singapore. Similarly, this requirement is now applicable not only at initial listing but also on a continuing basis.

Existing listed entities, foreign or otherwise, have up to 1 January 2008 to comply with the revised rules.

## B. Accounting for financial guarantees

### What is a financial guarantee contract?

A financial guarantee contract is defined as one that requires the issuer to make specified payments to reimburse the holder for a loss he incurs when a specified debtor fails to make payment when due, in accordance with the terms of the debt instrument.

### What is the current position?

Financial guarantees entered into by a non-insurance entity are generally accounted for under FRS 37 *Provisions, Contingent Liabilities and Contingent Assets*. In such instances, no liability would be recognised by the entity unless it is probable that the entity would be required to make a payment under the guarantee.

### How is the current approach different from the amendments to FRS 39 and FRS 104?

The key result of these amendments is to require some form of financial instruments accounting for these guarantees. By default, all entities are required to account for financial guarantees under FRS 39. This is unless the entity had previously made an explicit statement that they considered the guarantees to be insurance contracts, and had used accounting applicable to insurance contracts. In such a case, the guarantees would be accounted for under FRS 104.

### How should financial guarantee contracts be accounted for under FRS 104 by non-insurance entities?

If a guarantee arrangement is accounted for under FRS 104 by a non-insurance entity, the guarantee arrangement should be disclosed as a contingent liability. A liability is only recognised if payment becomes probable. This treatment is consistent with the current position in accounting for financial guarantees by non insurance entities.

### How should financial guarantee contracts be accounted for under FRS 39?

If a guarantee arrangement is accounted for under FRS 39, the issuer must:

- initially recognise the guarantee liability at its fair value (regardless of whether any consideration is given); and
- subsequently measure the guarantee liability at the higher of:
  - The initial fair value under FRS 39, less cumulative amortisation recognised in accordance with FRS 18 *Revenue* and
  - the amount that would be recognised under FRS 37.

### Are intra-group financial guarantees within the scope of these amendments?

Yes. The revised FRS 39 or FRS 104 applies equally to intra-group guarantees.

An example of an intra-group guarantee is where a parent issues a financial guarantee to a bank in respect of banking facilities the bank extends to its subsidiary. The parent would account for such a guarantee in its standalone financial statements.

In most instances, intra-group guarantees are issued at nil consideration. The issuer would then recognise a liability for the intra-group guarantee at fair value. The difference between fair value and consideration would be accounted for as either:

- a distribution (where guarantee is given for the benefit of a parent or sister entity); or
- an investment in subsidiary (where guarantee is given on behalf of a subsidiary).

## C. Developments in international standards and interpretations

### Exposure Draft Proposed Amendments to IAS 32 and IAS 1 – *Financial instruments Puttable at Fair Value and Obligations Arising on Liquidation*

Refer to IFRS Briefing Sheet 51 for details

The proposed amendments will affect the classification of ordinary shares in entities such as limited-life and co-operative entities.

Currently, an entity whose shares can be redeemed at fair value at the discretion of its holders has to classify these shares as a financial liability. Hence, ordinary shares which entitle the holders to a pro-rata share of net assets at liquidation are classified as a financial liability if the liquidation date is determined at inception.

Preparers and users of financial statements were concerned that such classification did not reflect the equity nature of these shares. Consequently, the International Accounting Standards Board has proposed limited amendments to IAS 32 to rectify this anomaly.

The Exposure Draft proposes that the definition of 'financial liability' be amended to exclude the following:

- an obligation to deliver a pro-rata share of net assets of the entity upon liquidation; or
- an obligation to redeem or repurchase a financial instrument puttable at fair value.

When implemented, entities will be able to classify their ordinary shares as equity if the shares are the most subordinated class of shares with a claim to net assets of the entity, and they meet either of the above conditions.

However, in the consolidated financial statements, such shares held by the minority shareholders will still be classified as liabilities. This is because these shares are not the most subordinated class of shares with a claim to net assets of the entity.

The CCDG has issued an identical exposure draft in Singapore on 3 July 2006, with comments due by 23 September 2006.

### Exposure Draft Proposed Amendments to IAS 23 *Borrowing Costs*

Refer to IFRS Briefing Sheet 50 for details

The Exposure Draft proposes that an entity should capitalise borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset, as part of the cost of that asset. The option to recognise borrowing costs as an expense in the profit and loss account is removed.

The CCDG has issued an identical exposure draft in Singapore on 31 May 2006, with comments due by 29 August 2006.

The KPMG International publications covered in this issue are:

- IFRS in Brief: issues 25 & 26
- IFRS Briefing Sheet: issues 50 to 53

Electronic versions are available at **kpmg.com.sg**

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